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CURRENCIES AND CREDIT MARKETS

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"When Americans look back on the depression of the 1990s, what we will remember is the denial. Not simply the semantic denial, the absence of the "D" word, the vocabulary tango of recessionary this and downturn that. We will remember the years when we tried to pretend that nothing was wrong, that everything was as it had been."

Anna Quindlen, International Herald Tribune, Oct. 23, 1990

HIGHLIGHTS

Overwhelmingly, the common expectation remains that the dollar will bottom out shortly without much further downside risk and will then be followed by a rebound back to the DM 1.65-1.70 range in 1991. The consensus remains complacently unperturbed by the massive dollar fall so far.

The much ballyhooed Purchasing Power Parity theory (PPP) continues to give solace to the dollar-bulls. A historical perspective of the PPP, though, shows that it has virtually no forecasting value.

In order to reasonably expect the dollar to strengthen again, the United States must attract net capital inflows in excess of $150-200 billion or more annually. U.S. capital inflows of this size are just simply impossible.

The dollar's plunge has its obvious cause in the U.S. capital account. Formerly huge foreign purchases of dollar assets have stopped abruptly. Dollar assets are unappealing as never before.

The fact to remember about the 1987 dollar crisis is this: the dollar collapsed despite the benefit of large and widening interest rate advantages against the D-mark and the yen. Almost all comparisons of the relevant fundamentals of between now and 1987 have deteriorated for the dollar.

The present U.S. credit crunch has its cause in too many over-indebted borrowers and a host of undercapitalized banks. All the while, monetary policy has really been unrestrictive in terms of available reserves and interest rates levels. Consequently, something extremely uncommon is occurring: a credit crunch marked by falling interest rates.

Many are mystified why the price of gold bullion has not responded more strongly to a falling U.S. dollar. We think we have the explanation.

We are inclined to think that an investment in hard-currency bonds will far outperform gold bullion over time . . . even in the event of a serious dollar crisis.

So far, there is still no sign of any bullish speculation in the D-mark. It's been the fundamentals of economic, financial and monetary conditions that have dominated currency markets trends so far.

A raucous, speculative phase for currency markets still lies ahead. Plainly, the U.S. economy, the U.S. financial system and the U.S. dollar are drifting into an unprecedented peril.

THE WORST IS YET TO COME

During past months, investors worldwide have suffered heavy losses — concentrated mainly in stocks, real estate and currencies. The worst hit of all, though, were the many European investors holding dollar assets . . . that is, dollars of every denomination: U.S., Canadian and Australian. These investors lost twice over, first on the asset price, and second, on the currencies.

Conversely, dollar-based investors who moved into European hard-currency bonds early enough — those denominated in D-mark, Swiss, French and Belgian francs, Dutch guilders, and Austrian shillings — fared best of all. Any bond-price losses that arose on foreign holdings as a consequence of recent rises in interest rates were limited and more than abundantly offset by currency gains.

Nobody speaks of a dollar crisis, however. "Orderly decline" is the preferred description of the U.S. dollar's plunge against the D-mark and also lately against the yen. Yet, as the following table shows, the orderly slow-motion movements in the currency markets have added up to substantial exchange losses/gains in the meantime.

As is by now well known, between 1985 and 1989, international investors domiciled in low-yielding hard-currency countries chased high-yielding currencies aggressively. Since governments seemed to promise a regime of stable exchange rates, the lure of high nominal interest rates became simply irresistible for many investors regardless of adverse inflation differentials and outsized deficits. The mania reached its peak in 1988, following the dollar crisis of 1987.

APPRECIATION OF THE D-MARK

	Last Year's Lows	Recent Rate*	Decline in %
U.S. Dollar	2.0400	1.4945	-26.7%
Canadian Dollar	1.6975	1.2830	-24.4%
Australian Dollar	1.6725	1.1610	-30.1%
Sterling	3.2840	2.9280	-10.8%

* Priced as of November 2, 1990.

In 1988 and early 1989, these investors reaped big profits both in terms of high interest income and the substantial exchange-rate gains that resulted from the huge capital inflows into these currencies. It seemed a fool's paradise.

But, alas, the exchange losses that the high-yielding currencies have suffered against the D-mark and other related European currencies have already wiped out any prior profits. Most of these bonds are now held at a loss. And since most people don't like to take a loss, they will, in our view, end up with even bigger losses.

How low can the dollar go? What do markets believe and what do the experts say?

THE CONSENSUS ON THE DOLLAR IS STILL CONSTRUCTIVE

Recently, the Wall Street Journal carried an article that sampled the dollar forecasts of 10 currency analysts, representing a mix of leading international financial institutions, banks and brokers. The most striking feature of the survey was the conformity of the forecasts. The common expectation was that

the dollar would bottom out shortly without much further downside risk and would then rebound back to the DM 1.65-1.70 range during 1991.

It is a fact that the dollar's plunge to new lows against the D-mark has caught the great majority of analysts and international investors completely by surprise. Obviously, many are still at a loss to understand why. For them, the D-mark had to weaken under the supposed inflationary impact of German currency union and soaring unification costs.

Instead of asking themselves why they have been so terribly wrong about the D-mark and the dollar, they frantically look for reasons why the dollar must rise again. Thus, all of a sudden, the Purchasing Power Parity (PPP) theory has become the great rage among American and British economists.

It is obvious why this outmoded theory has had such an astonishing renaissance. Nothing else is left with which to explain a possible stabilization of the dollar.

Look at this sobering statement: "*The purchasing-power parity doctrine has had its ebbs and flows over the years. Interest in the doctrine arose whenever existing exchange rates were considered unrealistic and the search began for the elusive concept of equilibrium rates.*" This statement is excerpted from an article in the U.S. Journal of Political Economy of 1964, volume 73, page 584.

To give a detailed explanation of all the fallacies of the PPP doctrine would be a waste of time. (Please see our comments in the August letter this year.) However, we can't resist making a few more remarks.

DEBUNKING THE PURCHASING POWER THEORY

Firstly, it's worth recalling that not one of the great economists on the subject of international trade — F.W. Taussig, Jacob Viner, Gottfried Haberler — has ever accepted the PPP doctrine.

A crucial point that invalidates the PPP doctrine is that international trade flows are determined by many factors other than just prices. Considerations of quality, changes in preferences and techniques and changes in supply and demand structures are some of the important factors that are overlooked. One simple question beckons: How can a grossly undervalued dollar boost U.S. exports if American industry fails to build the necessary industrial capacities to take advantage of it?

The most glaring problem with the PPP is that it ignores the influence of capital flows on exchange rates. A brief history of the doctrine reveals why. The inventor of the PPP doctrine was Swedish economist Gustav Cassel. Asked about capital flows, he answered that they were not powerful enough to cause a wide divergence in the comparative purchasing powers of any two respective currencies. Guess what year it was that Cassel unveiled his theorem? It was in 1920, just after World War I.

Just after the war, governments in Europe were all grappling with the problem of how to determine new gold parities for each of their currencies. It was then, in a Memorandum for the International Financial Conference in Brussels, that Cassel advocated his newly-formulated "purchasing power parity" idea.

Clearly, conditions in 1920 were as different from today as night is to day. Cassel's PPP was conceived within the framework of fixed exchange rates and at a time when capital flows played little if any role.

Today, of course, currencies float and capital flows are of such gigantic dimensions that they have become a major if not dominating influence on exchange rates.

Given those conditions in 1920, it certainly made sense for governments to employ the PPP as a tool to figure out reasonable exchange rates for their currencies. However, to use the theory as a exchange rate forecasting tool under a system of floating exchange rates and huge capital flows is outright foolishness.

How does the PPP relate to capital flows? As the dollar sinks lower, of course, U.S. assets become cheaper and cheaper. Many economists believe that this should be a splendid reason to load up on cheap dollar assets. Our answer to this rationale? Nonsense.

The cheapness of U.S. assets is an illusion because, for the investor calculating in his own currency, a low dollar translates into correspondingly low yields. In other words, at a dollar rate of DM 1.50, the German investor pays much less for a U.S. asset in his own currency than at the rate of DM 2.00. However, the lower exchange rate also means correspondingly less D-marks for his dollar-earnings. This phenomenon holds equally true for both financial and real assets, and that's why the present "cheapness" of dollar assets is an illusion. The hard reality is that countless international investors who had bought "cheap" dollar asset over past years are now sitting on losses. These assets are becoming cheaper and cheaper everyday in terms of their own currencies.

In conclusion, forget about the PPP. Whether the "cheap" dollar will ever recover or become even a greater bargain will basically depend on the U.S. economy's future health and strength and its underlying monetary and fiscal policies. If these fundamentals improve, the dollar's downtrend is limited. And if not, the bottom is still a long way off.

CAPITAL FLOWS TIP THE SCALES

What, then, has depressed the dollar since mid-1989 despite continued trade improvement? In short, a dramatic reversal in capital flows. Prior huge capital inflows have turned into a small outflow . . . the first since the 1970s.

This is what the recent U.S. Commerce Department's Survey of Current Business, September 1990, reports regarding U.S. capital flows: *Foreign holdings of U.S. assets diminished in the first half of 1990 by almost $22 billion at an annual rate, compared with net capital inflows of $221.4 billion in 1988 and $214.6 billion in 1989.*

As it turns out, the U.S. current-account deficit was financed by capital inflows that were unaccounted for and also, to a lesser extent, by banking sector inflows. The Commerce Department shows a record "statistical discrepancy" of $96 billion. To us, that suggests one source: hot money from the Euro market.

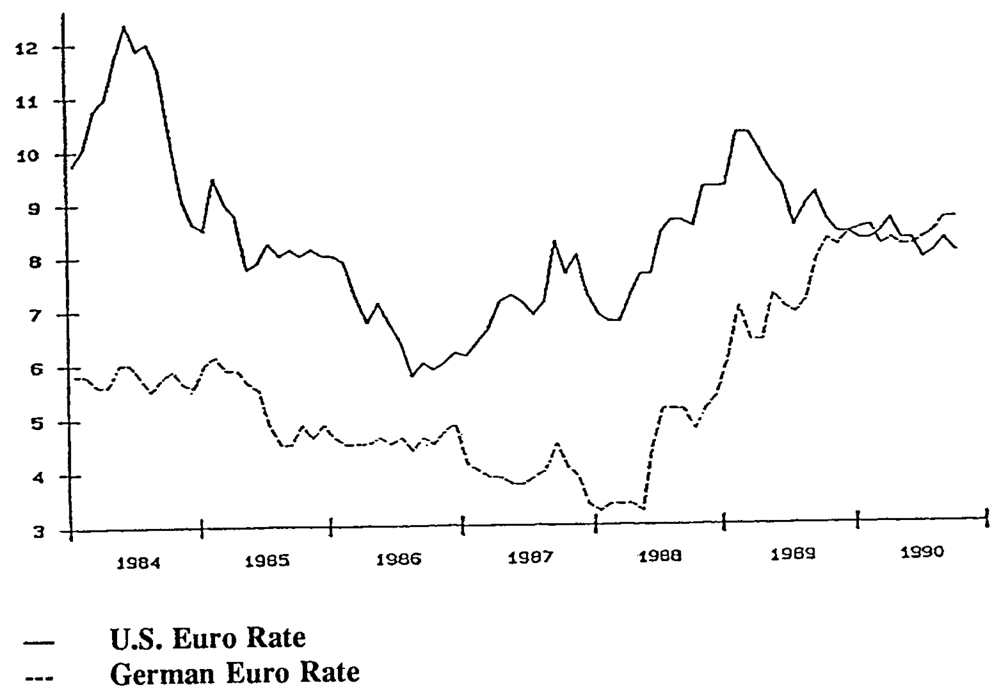
At any rate, it is clear what has been depressing the dollar. Foreign investors have been shunning U.S. investments. The key consideration for the dollar-forecaster therefore is to assess the potential strength of the U.S. capital account over the coming months and years relative to the prospective U.S. current-account deficit.

Given the dismal state of the U.S. economy, we don't see any reason for a big new rise in foreign capital inflows, either direct or portfolio investment. The dollar's fate, therefore, hinges on continued massive short-term (hot) money inflows. As for the plausibility of such a prospect, take a look at the following chart showing short-term interest rate differentials between the D-mark and the U.S. dollar from early 1985. Conditions for short-term money inflows are equally bleak.

For the first time since the early 1970s, interest rate differentials are working against the dollar. It is worth recalling that during 1985-87, the dollar collapsed despite large interest rate advantages against the D-mark. Today, three-month Euro-deposit rates already favour the D-mark by 0.70-0.80 percentage points and are set to widen further.

In order to reasonably expect the dollar to strengthen again, the United States would need to attract net capital inflows in excess of its current-account deficit of $100-120 billion plus an offsetting amount to cover capital outflows. To finance them both would require an annual inflow of foreign capital totalling $150-200 billion plus, taking into account that U.S. private capital outflows are considerable and quite volatile.

US AND GERMAN 3-MONTH EURO RATES
(Monthly Average)



Source: Datastream

Our assessment of this requirement is that U.S. capital inflows of this size are simply just impossible. What's more, as things go from bad to worse in the U.S. economy, conditions for future capital flows can only become more repelling. The non-resident's willingness to invest his savings can only decline.

We wonder if all the dollar optimists have forgotten what happened only three years ago in 1987. The conditions of that year relative to those of today bear reviewing. Let's briefly recapitulate the dollar horror story of that year.

THE LESSONS OF 1987 FOR THE DOLLAR

The big dollar rise of the early decade — the product of the Reaganomics hoopla — ended on February 26, 1985 at DM 3.45 and ¥ 263. By the end of 1985 the dollar had fallen to DM 2.51 and by year-end 1986 further to DM 1.99.

Even though the U.S. trade deficit was widening rapidly, therefore necessitating rising capital inflows to cushion the dollar's fall, foreign capital was readily forthcoming. That happened mainly for two obvious reasons: economic weakness and monetary ease outside the United States and booming U.S. securities markets which made U.S. investments highly attractive for the foreign investor who perceived only limited exchange risk.

In the end, exchange risks proved far greater than had been generally expected. Fortunately for the foreign investor, rich capital gains on U.S. stock and bond positions amply compensated for the disappointment. Between the end of 1984 and early 1986, yields on 30-year U.S. Treasury bonds nose-dived from 13.5% to 7.5%. The capital gain was a gratifying 60%.

During 1985-86, everything went rather smoothly. The United States experienced the unusual and congenial combination of a sharply declining dollar along with sharply declining interest rates. However, by late 1986 and early 1987, this comfortable state of affairs changed radically. Bond gains reversed as a bear market in bonds began all the while that the dollar continued to decline. And since foreign investors perceived that the downside risk of the U.S. dollar was still substantial, private investment inflows fell to zero abruptly.

At the same time, existing foreign dollar holdings were increasingly hedged against further dollar depreciation . . . that is, dollars were sold in the forward market. In general, hedging leads to a corresponding borrowing of dollars in the Euro markets, the proceeds of which are then immediately sold for a hard currency such as the D-mark or yen.

By March of 1987, a full-fledged financial and currency crisis was in progress. While central banks bought dollars in seemingly unlimited amounts, U.S. Euro-dollar rates and long-term bond yields shot up, though the Fed kept its funds rate rather stable at around 6%. Thirty-year U.S. Treasury yields soared from 7.5% to a level of 10.6% just prior to the stock market crash of October that year.

Why this recollection? Because we want to draw attention to the tremendous differences in the underlying economic, monetary and financial conditions between then and now.

The salient point to see today is the following: compared to 1987, one condition has improved while everything else has deteriorated. The U.S. current-account deficit has shrunk from $162 billion to $110 billion. Before the recent oil price hikes, it was widely expected that the trade deficit would fall to the $90 billion range.

As we already mentioned in the discussion of the PPP, this singular positive comparison plays an oversized role in the arsenal of the dollar-bulls. What these people overlook, however, is the dramatic reversal of conditions for capital inflows from highly attractive to repelling . . . in fact, more repelling than in the last 10 to 20 years.

The negative comparisons abound. In 1987, U.S. economic growth was still above the world average. U.S. GNP grew 3.4% against a 1.8% rate in Germany. Today, it's the reverse. Germany's GNP is expanding at a rate of 4%, Japan's is at almost 6%, while the U.S. economy teeters on the edge of recession.

What's crucially important about this growth reversal are the implications for relative monetary and credit conditions and consequently for capital inflows. In 1987, foreign central banks which were faced with weak domestic economies sharply lowered their interest rates to stimulate growth and to support the dollar. As a result, the dollar enjoyed a large and steadily widening interest-rate advantage.

This time, both the German and the Japanese economies are booming with heavy domestic credit demand. To contain inflation, these countries need high interest rates. And both central banks make no secret of the fact that the falling dollar is very much to their liking as an antidote to inflation.

INTERNATIONAL CAPITAL FLOWS: A COMPLETE TIDE CHANGE

True, America's current-account deficit is considerably smaller than in 1987. But, by historical standards it's still huge, exceeding $100 billion per year. This time, the dollar has to attract the necessary foreign capital with the unattractive carrot of negative interest rate differentials against all other currencies — notably against the D-mark and yen.

We wonder and wonder how that's possible over the longer run. The only conceivable scenario we could foresee is that the anticipation of a dollar recovery triggers an avalanche of hot-money flows. Clearly, there must be people who are prepared to bet that the dollar has gone down too far — at least temporarily — and that it must recover sometime in the future. One buoying factor seen already, certainly, is the Gulf crisis. Without that, in our view, the dollar would already be much lower.

The most salient aspect of the comparison with 1987 has to do with market psychology and confidence. Then, the U.S. economy was clearly in far better shape than it is today. Additionally, the dollar enjoyed the support of large and widening interest rate advantages against the hard currencies. And, last but not least, foreign central banks were desperate to stabilize the dollar by sharply lowering their own interest rates and by massive interventions. Nevertheless, one thing cracked: confidence.

In hindsight, it is clear that the 1987 dollar disaster was an out-and-out confidence crisis. In turn, it triggered devastating effects on the U.S. financial markets even though the U.S. economy was in the stage of recovery.

Today, it's exactly the opposite. Underlying conditions for the U.S. economy and its currency are going from bad to worse, yet currency and financial markets remain remarkably unflustered. The result we see, therefore, are slow-motion declines . . . at least until confidence breaks.

No doubt, many Americans are deeply worried as individuals. The Conference Board's survey of consumer confidence has plunged steeply to an eight-year low. The Board's measure of business sentiment dropped to the lowest level since 1980. Compared to such and other devastating economic and financial news, it's mystifying why markets appear so very composed.

CURRENCY MARKETS: STILL NO SIGN OF OVERSHOOTING

It strikes us as obvious that there is no currency speculation going on. As already mentioned, given a dollar decline of 26.7% against the D-mark since mid-1989, the best investment for the dollar-based investor in this period would have been European hard-currency bonds returning between 9% to 10.5% in current yield plus the rich currency gains. In the past, in fact, it was normal that currency speculation was heavily concentrated on the bond market of the appreciating currency. However, the German bond market shows absolutely no trace of it.

Despite recent modest net purchases, foreigners have been net sellers of DM 5.9 billion of German bonds in the first eight months of this year. The force that buoyed the German capital account and thrust the D-mark upwards was exclusively the German investor who turned from purchasing high-yielding foreign currency bonds to domestic bonds. Total domestic net purchases of domestic bonds amounted to DM 105 billion of which DM 91.4 billion was accounted for by non-bank investors. Total domestic purchases for the same period last year amounted to only DM 39.8 billion.

By contrast, during the dollar crisis of 1986 and 1987, foreigners stampeded into the German bond market purchasing amounts of DM 59 billion and DM 34 billion, respectively. Even now, considering the strong performances of European fixed-income instruments, it strikes us how rarely international investment services — particularly so North American ones — recommend European hard-currency bonds as a "safer haven" against a falling dollar.

WHY GOLD LANGUISHES AND THE D-MARK SOARS

Americans who are bearish on the dollar, tend to prefer gold as the best hedge against a falling dollar. There is a belief that a weak dollar must always express itself in a rising gold price. In our opinion, that view is a great fallacy. The two are really as different as apples and oranges and are not directly related. The dollar is a currency and gold is an asset.

Let's first have a look at the gold price movements since 1980, as seen in the chart on the next page. It shows two strong upward movements during the 1980s, one in the second half of 1982 and the other between 1985 and 1987.

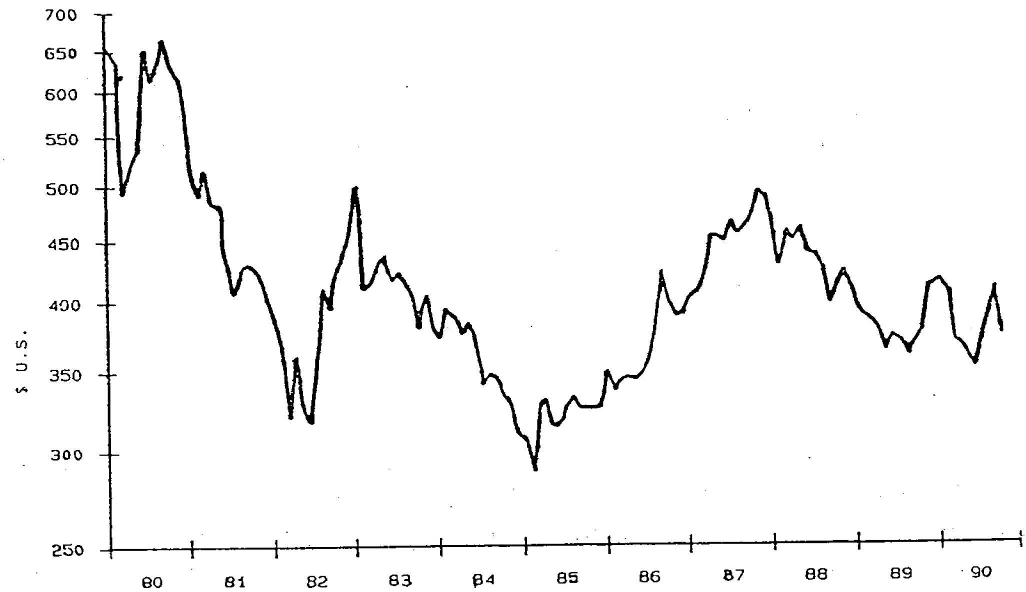
What happened in these two phases that explains the two bull runs? Well, in our view, it was an aggressive Fed easing . . . in other words, a massive monetary over-expansion.

After each of these periods there followed a phase of gold weakness which wiped out most of the prior gains. What about the monetary stance in these periods? Money was not certifiably tight, but it was relatively tighter than before. Obviously, that was sufficient to depress the gold price.

Since mid-1989, the Fed has distinctly eased, lowering its Fed funds rate from almost 10% to 7.75% presently. Yet, after a short spurt, the gold price is back to where it was while the D-mark has returned a gain of 25% against the dollar plus interest income. We would say that the difference between the performance of the D-mark and gold bullion is more than striking.

It is true, of course, that a falling U.S. dollar and a rising gold price have generally gone together. But

GOLD BULLION PRICE
(U.S Dollars per Ounce, Month End to October 1990)



Source: SMH-Research

the key question, though, is the causal relationship between the two. Strictly speaking, there is none — apart from the effects of psychology.

What tends to cement the inverse relationship between gold and the D-mark is in reality a third factor: a strange mix of tight and easy money at the same time. This factor offers a succinct explanation for the present scenario of a falling dollar and the absence of a rising gold price.

A NOVELTY: A CREDIT CRUNCH WITH FALLING INTEREST RATES

As we have seen, the gold price tends to rise during times of monetary inflation in the United States. Presently, there is no monetary inflation. Rather, there is the opposite — a credit crunch distinguished by a very unusual feature. It's not a normal type of credit crunch that is caused by a tightening monetary policy and rising interest rates. This is a credit squeeze that has its cause in too many over-indebted borrowers, sliding asset prices and undercapitalized banks. After all, monetary policy is really unrestrictive in terms of reserve availability and interest rate levels. Consequently, **we are witnessing something that is extremely uncommon: a credit crunch marked by falling interest rates.**

The credit crunch (or liquidity squeeze) is now impacting the U.S. economy and its asset markets. As the credit expansion slows, domestic demand and output slow. But worst hit are asset prices, stocks, real estate and bonds — specifically those of questionable credit quality while treasury paper profits from a flight to quality. And gold? Well, gold, after having been demonetized in 1971, is really just another asset. Furthermore, it's an asset without any current yield. There is no rational reason why gold

should rise in an environment of generally plunging asset prices.

Yes, it's true that gold was the best investment during the 1970s. However, gold's rise then was largely a one-time price adjustment due to the fact that the central banks had held the gold price at the artificially low price of $35 ever since President Roosevelt fixed the price in 1931.

The usual speculative mania, then, briefly drove the price up to $800 per ounce. Gold had first reached the $400 level in 1979. Since that time, however, the dollar's domestic purchasing power has depreciated by 60%. Despite this massive currency decline, gold is nonetheless still trading below $400, as it has for much of this year.

For the sake of illustration, how would an American investor have fared with a purchase of D-mark bonds in 1979? In the interim, the investor would have showed a currency gain of 15% and compound interest income amounting to another 100%. Assuredly, gold has provided some good trading opportunities like any other commodity. Nevertheless, it has failed miserably as a long-term investment or as a hedge against inflation.

The dollar is a currency, and by definition, a falling dollar means a decline against other currencies — namely, the hard currencies. Presently, the dollar is falling against the D-mark and other currencies for many obvious reasons: a weak U.S. economy, a widening trade deficit and negative interest rate differentials. These things are not bullish for the dollar, and neither are they bullish for gold.

Yet, having said that, we should close with a caveat. We do not exclude the possibility that there could be a stronger rise in the gold price in the future. Such a trend, though, will need more than just a falling dollar. What is required is a true dollar crisis approaching the panic levels of 1987, if not worse. That's something we still reckon with. However, even so, we don't think that gold will beat a high-yielding hard currency over time.

NO DOLLAR CRISIS YET

The other day somebody asked us how a credit crunch affects a currency. The answer, of course, as we often discuss in this letter, is that it depends on a host of particular conditions.

The two extra-ordinary situations, currently, are the United States and Japan. Plunging asset prices are destroying collateral values and ravaging the banking system's capital base in both countries. As a result, the banks must retrench.

However, there are two crucial differences between Japan and the U.S.. The United States is a debtor, deficit country, while Japan is a creditor, surplus country. America is handicapped by the requirement of an incessantly huge capital inflow corresponding to its $100-plus billion current-account deficit in order to maintain its dollar rate.

Whenever U.S. capital inflows fall short of the current-account deficit, the dollar falls. That is what is happening at the moment, for which the reasons are all too obvious: low and unattractive U.S. interest rates and bleak conditions in the U.S. financial and real estate markets.

There is absolutely no reason why a foreign investor should be long the dollar and even less reason to consider the purchase of any dollar asset. Wherever one looks, there are nothing but risks, whether in the currency, stocks, bonds or real estate — not to mention the most unattractive interest rate levels in the world. As long as conditions in other countries and currencies are more attractive, there is no bottom in sight for the dollar, neither at DM 1.50 nor DM 1.40.

Nevertheless, it seems that worldwide psychology is still quite complacent about the dollar . . . more so outside North America. Despite all the news of economic weakness and financial stress, non-Americans continue to feel assured that America will somehow manage its problems. When that confidence finally disintegrates, we will face the real dollar crisis.

ANOTHER CREDIT CRUNCH: A GLOBAL ONE

As we have always stressed, currency values are subject to influences from two sides: internal and external. The heightened vulnerability of the dollar today is a double function of extremely negative conditions for capital flows both in terms of internal and external conditions.

What hits the dollar now over and above the deteriorating domestic fundamentals is confluence of two extra-ordinary developments in Germany and Japan. Japan is facing a credit crunch while German capital requirements for the rebuilding of East Germany are beginning to soar.

In the case of Japan, it is well known that Japanese banks and investors pumped hundreds of billions of dollars into U.S. stocks, bonds, real estate and corporate takeovers during the past half-decade or so. In a sense, you could say, that Japan store-housed liquidity in U.S. capital markets. Now, given the combination of a drastic monetary tightening, crashing stocks, and a softening real estate market in Japan, Japanese banks and investors are forced to curb their investments and lending abroad . . . not to mention repatriating funds (liquidity) from overseas markets. This boosts the yen and depress the dollar.

The upshot of this combination of extra-ordinary events in the two major creditor and surplus nations of Japan and Germany is that, by necessity, their capital outflows must dry up. Increasingly, German and Japanese capital stays at home. Though, both countries have shrinking current-account surpluses, their capital outflows implode much faster. In this regard, our September letter spoke of a dramatic "sea change" within world capital flows and currency markets.

This "sea change" in capital flows is further reinforced by the fact that the deficit countries — including America, Britain, Canada, Australia and Sweden — are sliding into recession one by one. Weakening economies inevitably result in easier and lower interest rates, therefore slowing capital inflows and undermining their currencies. In sum, the high-yielding currencies are in for trouble.

SUMMARY CONCLUSIONS

Most market participants, it seems, cannot imagine that the dollar might fall much further yet. To them, the arguments of the purchasing-power parity theory become all the more alluring. They thought so at DM 1.70, again at DM 1.60, and now at DM 1.50. In the meantime, unfortunately, the best investment opportunity of 1990 was totally missed: that being the DM-bloc bond markets. It appears, though, that

the deeper the dollar falls, the greater the disbelief that the dollar can fall further.

All the same, one should ask whether the continued rise of the D-mark might largely be a speculative bubble. The tendency for currencies to overshoot is well-known. The salient fact is that there is no trace of any such speculation. Most international analysts, after all, have been rather bearish on the D-mark for reasons of the German monetary union and rising unification costs.

The most striking manifestation of this overwhelming bearishness is that foreigners have been net sellers of DM-bonds during the year. The D-mark's rise was based on one thing only: on the excellent economic, monetary and financial conditions in Germany relative to the extremely negative economic, monetary and financial conditions in the United States and other countries.

Not only that, apparently most people have yet to grasp the seriousness of the threatened economic and financial debacle that looms as the recession in the United Sates and other countries deepens. It seems clear to us that a cumulative and interactive deterioration has begun in the U.S. economy and its financial system.

What's worse, given this darkening of fundamentals, is that investment professionals seem to see it as another opportunity to regard bad as good. Either contrarian investing is at the height of its vogue or investment managers are simply frozen at the wheel as the inescapable negativeness of the situation looms into view. While sentiment has certainly turned negative, investment portfolios do not reflect this sentiment. Investment in stocks remains near all-time highs while conservative cash investments are shunned. The private investor, on the other hand, is finding refuge in cash in record numbers.

There is a widespread view that the Fed cannot and will not ease aggressively given the vulnerability of the U.S. dollar. A gathering recession will set its own timetable for a substantive Fed easing. When the day comes that the Fed will have to decide between the two priorities of trying to prop up the banking system or the currency, it's clear that the security of the banking system will win out. Plainly, the U.S. economy, the U.S. financial system and the U.S. dollar are drifting into an unprecedented peril.

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